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## The Disturbed Subtenant

Roger Bernhardt

*Syufy Enters., LP v City of Oakland* (2002) 104 CA4th 869, 128 CR2d 808 (reported on p 172) is an object lesson in showing that what is often considered as inconsequential boilerplate can, in the end, really make a difference. The lack of such language in a master lease here really hurt an innocent subtenant. The prime tenant had filed bankruptcy and had its master lease “deemed rejected” because of its earlier defaults. That rejection entitled the landlord to evict the subtenant even though the sublease had never been in default and the subtenant had not even been notified of the prime tenant’s bankruptcy.

As a matter of lease law, that decision was certainly correct. A sublease is merely a derivative of the master lease, and when one goes so does the other. There are some exceptions in favor of the subtenant (“she”) when the prime tenant (“he”) voluntarily surrenders his leasehold to the landlord (“it”) or acquires the fee estate for himself. Those outcomes, however, derive from the prime tenant’s implied duty of quiet enjoyment to his subtenant and do not inhibit a bankruptcy judge’s power to reject executory contracts. Thus, termination of the master lease necessarily takes the subordinate subleases down with it.

Although termination was hard on the subtenant in this case, in other situations it could be equally hard on the landlord—*e.g.*, when the landlord may have been counting on the subrent to cover the rent it was to receive for the balance of the term. Both landlord and subtenant may want the same kind of security that motivates landlord and tenant (and master tenant and subtenant) to enter into their own binding long-term arrangements in the first place.

That security may be obtained, but it does not arise automatically. A binding long-term lease between landlord and tenant, combined with a binding long-term sublease between tenant and subtenant, do not together amount to a binding long-term arrangement between landlord and subtenant that will survive the disappearance of the intermediate tenant. That arrangement has to be accomplished separately, in one of two ways.

First, appropriate provisions can be included in the master lease when it is initially executed that will make a later-executed sublease effectively binding on landlord and subtenant. Or, second, comparable provisions can be included in the sublease or in a separate document accompanying the sublease when it is later executed. There are virtues in both approaches, and the best arrangement would be to use both.

A major virtue of the first arrangement is that it was used and upheld in *Chumash Hill Props. Inc. v Peram* (1995) 39 CA4th 1226, 46 CR2d 366. This outcome is in striking contrast to *Syufy*. The sublease in *Chumash Hill* survived the prime tenant’s bankruptcy and deemed lease rejection because of good language in the original master lease. That lease provided that, in the event of an incurable default by the prime tenant (*e.g.*, filing bankruptcy), then the “sublessee’s possession and use shall not be disturbed by lessor or by mortgagee as long as . . . sublessee performs his sublease’s provisions . . . [and] attorns to lessor and mortgagee.” The court of appeal held that this provision—a kind of nondisturbance and attornment (NDA) clause—was

not defeated when the master lease (which included it) was deemed rejected in bankruptcy, was enforceable by the subtenant as a third party beneficiary, and did not violate public policy. That's about as good as it gets.

While the *Chumash Hill* landlord may have been annoyed for having included such a clause in the lease, it is equally likely that that was exactly what it originally wanted—the security of knowing that it would have a back-up tenant even if its main tenant later failed.

That means that if you represent a subtenant negotiating a sublease, you should check the master lease for the kind of protection it offers your client, and the kind of requirements your client has to meet to get that protection. You not only want to get the landlord's assent to your sublease (if that is required), but you also want some kind of estoppel letter from the landlord, acknowledging that the NDA provisions are still in force and that you qualify under them.

If you don't find that kind of provision in the master lease, it is not too late to create one. Indeed, a new arrangement between landlord and subtenant may be more effective than the old one between landlord and tenant, and could be created even though there were appropriate provisions in the master lease. Under an agreement directly between landlord and subtenant specifying contingent future arrangements between them in case of a prime tenant default, the subtenant acquires the status of an express beneficiary rather than an implied third party beneficiary of the old master lease (who may not have even been in existence at the time it was signed). Privity of contract is always helpful. As a two-party agreement, it would not require the prime tenant's assent, and it surely would survive his bankruptcy, if that ever happened. It would be wise for the subtenant to propose this new agreement even though the original lease already provided for it, especially if there are other details to be worked out—*e.g.*, the time gap between the different remaining terms of the lease and the sublease, other property that is included in the lease but not the sublease, and curing the tenant's existing defaults.

For a landlord who wants to be sure that the subtenant does not walk away on the main tenant's termination or bankruptcy, reliance solely on the provisions in the master lease is an invitation to arguments that the subtenant is not necessarily bound by them if she did not formally assume them (or even know of them). However, subtenants who agree to NDA provisions are effectively bound by all of the covenants in the master lease (*e.g.*, a "continuous operation" clause requiring the tenant to stay open whenever the shopping center is open (including Sundays or holidays), a clause requiring the tenant to keep its premises in repair or insured), in the sense that the landlord can terminate for failure to comply; it is less certain that a landlord can make a subtenant comply with the affirmative duties of attorning and remaining in possession after termination of the master lease when those provisions were neither assumed nor included in the sublease. A direct promise from the subtenant to become the new tenant if the old tenant is removed gives the landlord more security and allows it to tailor the arrangement to meet its own special new needs. (Think of it like a back-up offer to purchase.)

From the prime tenant's point of view, having a future NDA clause in his lease presents no risk to him and should make it easier to attract subtenants. Nor will the absence of such a provision in the master lease preclude the subtenant and landlord from negotiating one at the time the sublease is being arranged. The tenant should have no objection to those negotiations because it ought to be comforting to him that, if he later defaults, the subtenant's readiness to take over the lease will almost automatically mitigate his damage or rent liability under CC §§1951.2 and 1951.4.

Everybody seems so much better off when the subtenant is able to take over the master lease on a default by the prime tenant that it is too bad we do not have a statute ordaining such an outcome. But the same reasons that this outcome appears to improve everyone's condition make it easy to draft provisions bringing it about.

Of course, these provisions are only the beginning. After this basic arrangement between landlord, tenant, and subtenant has been worked out, the parties next have to deal with the rights, duties, and priorities of the fee mortgagee, the leasehold mortgagee, the tenant's assignees, and the landlord's purchasers. Who is subordinating what interest to which lien in return for what additional NDA provisions? But if that seems too complicated to work out in advance, just imagine what the litigation would be like if those arrangements haven't been made—think about poor Syufy Enterprises.

*Syufy Enters., LP v City of Oakland* (2002) 104 CA4th 869, 128 CR2d 808

After the master tenant was deemed to have rejected a nonresidential real estate lease in bankruptcy, the landlord evicted the subtenant, who operated a movie theater. The subtenant sued the landlord for, among other things, breach of contract based on its claim that it was a third party beneficiary of the master lease. The trial court found that the subtenant lost its right to possession of the property when the master tenant rejected the lease in its bankruptcy proceedings, and granted the landlord a judgment of nonsuit. The court of appeal affirmed, agreeing that rejection of the master lease terminated the subtenant's right of possession.

The court noted that federal courts have reached different conclusions on the subject; some bankruptcy courts have concluded that rejection results in a complete termination of the lease, while others have treated a lease rejection as a breach of the lease that does not adjudicate rights of third parties who *may* retain the right to assert their subservient interests. The court ascertained that the current trend in Ninth Circuit bankruptcy cases was to treat a debtor's rejection of a lease as a breach, rather than a termination, and that therefore the continuing viability of the sublease was a question of California law. Under California law, forfeiture of the master estate terminates the derivative interest of a sublessee. The court rejected the subtenant's argument that, because it enjoyed direct contractual privity with the landlord, its rights were not merely derivative. The court pointed out that the subtenant's asserted right to possession was based *entirely* on the master lease and its derivative sublease; there was no separate contract for the subtenant to enforce.